“Taking the strain”

The evolution of Employer Covenant assessment and how Covenant is being asked to absorb the current DB funding challenge

Current Issues in Pensions,

Institute and Faculty of Actuaries, London, 20 April 2016

Introduction: Matt Harrison

Contact

Matt Harrison

Tel: 07818 450 091
Email:
mharrison@lincolnpensions.com

Matt Harrison

Managing Director

- Extensive experience in advising trustees with respect to employer covenant and corporate transactions
- One of the principal architects of the pensions advisory business at EY
- Chartered Accountant and qualified insolvency practitioner

What Are We Covering?

1. What is Employer Covenant?
2. Integrated Risk Management
3. The Pension Funding Dichotomy
4. The Evolution of Employer Covenant Assessment

Lincoln PENSIONS

What is Employer Covenant?

Lincoln PENSIONS

TPR's Guidance

July 2014: Code of Practice 3 – Funding Defined Benefits

- TPR's view on how trustees should approach funding and scheme risks

August 2015: Assessing and monitoring the Employer Covenant

- Practical guidance on how to apply the Code of Practice:
  - engaging Employer Covenant advisors
  - assessing the Employer Covenant
  - monitoring the Employer Covenant
- Designed to support the approach adopted in the context of Code 3

TPR's publications have driven a change in focus on Employer Covenant assessment

Lincoln PENSIONS

What is the Employer Covenant?

"The Employer Covenant … represents the extent of the Employer's legal obligation and financial ability to support the scheme now and in the future"

TPR Code of Practice 03 – July 2014

July 2014 *Code of Practice* and August 2015 *Guidance* from TPR provide the regulatory backdrop to how we think about the Employer Covenant

Employers' legal obligation	• Understanding which entities are legally liable to support the scheme and the method of accessing that support
Employers' financial ability	• The financial position and prospects of a scheme's employers
Supporting the scheme - Investment risk	• The risk that the assets of the scheme perform worse than expected
Supporting the scheme - Funding risks	• The risk that the liabilities of the scheme are larger than expected

The Employer Covenant strength measures the <u>relative</u> ability of the sponsor to underwrite and fund the risks inherent in a Defined Benefit scheme

Independent review drivers – recent experience

Common themes

- **Nudges from Brighton**
  - Guidance, e.g. IRM
  - “The Regulator didn’t like our 2012 valuation…”
- **Events**
  - “We’ve always done it ourselves but now the employer’s up for sale”
  - “The management team has changed and/or we’re not sure about management’s plans for the business… we’re concerned”
  - Employer proposals, e.g. longer recovery plan, asset-backed contributions
- **Encouragement from advisors**
  - Direct/indirect covenant assessment

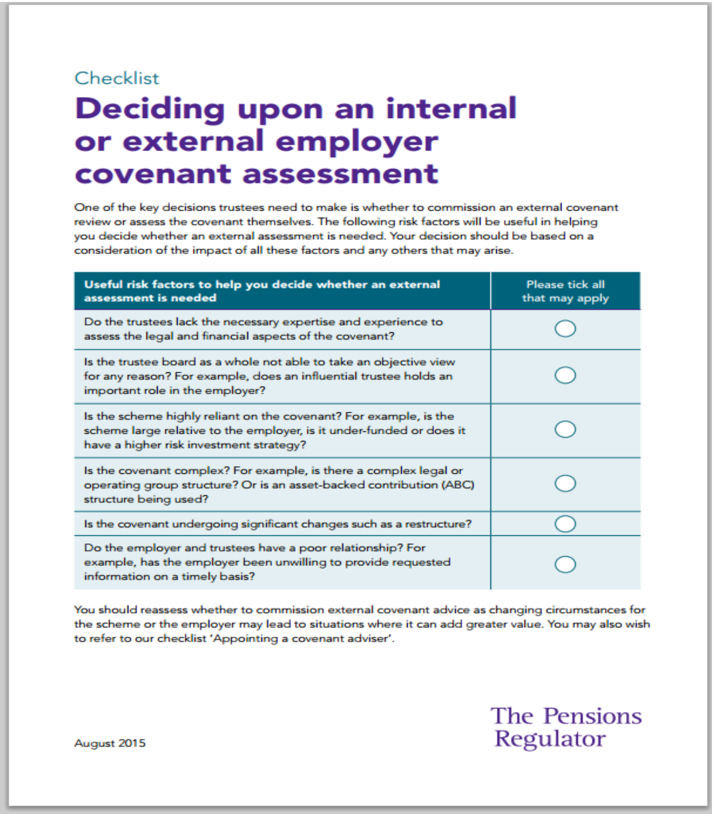
Fewer schemes able to make the case not to obtain independent covenant advice

When to commission an external covenant assessment

"Trustees should periodically reassess whether to commission independent covenant advice as changing circumstances for the scheme and employer may lead to situations where it can add greater value.

If trustees decide … to perform their own assessment they should be comfortable that they are able to perform adequately the steps set out throughout the guidance."

Assessing and monitoring the employer covenant, August 2015



Checklist

Deciding upon an internal or external employer covenant assessment

One of the key decisions trustees need to make is whether to commission an external covenant review or assess the covenant themselves. The following risk factors will be useful in helping you decide whether an external assessment is needed. Your decision should be based on a consideration of the impact of all these factors and any others that may arise.

Useful risk factors to help you decide whether an external assessment is needed	Please tick all that may apply
Do the trustees lack the necessary expertise and experience to assess the legal and financial aspects of the covenant?	○
Is the trustee board as a whole not able to take an objective view for any reason? For example, does an influential trustee holds an important role in the employer?	○
Is the scheme highly reliant on the covenant? For example, is the scheme large relative to the employer, is it under-funded or does it have a higher risk investment strategy?	○
Is the covenant complex? For example, is there a complex legal or operating group structure? Or is an asset-backed contribution (ABC) structure being used?	○
Is the covenant undergoing significant changes such as a restructure?	○
Do the employer and trustees have a poor relationship? For example, has the employer been unwilling to provide requested information on a timely basis?	○

You should reassess whether to commission external covenant advice as changing circumstances for the scheme or the employer may lead to situations where it can add greater value. You may also wish to refer to our checklist 'Appointing a covenant adviser'.

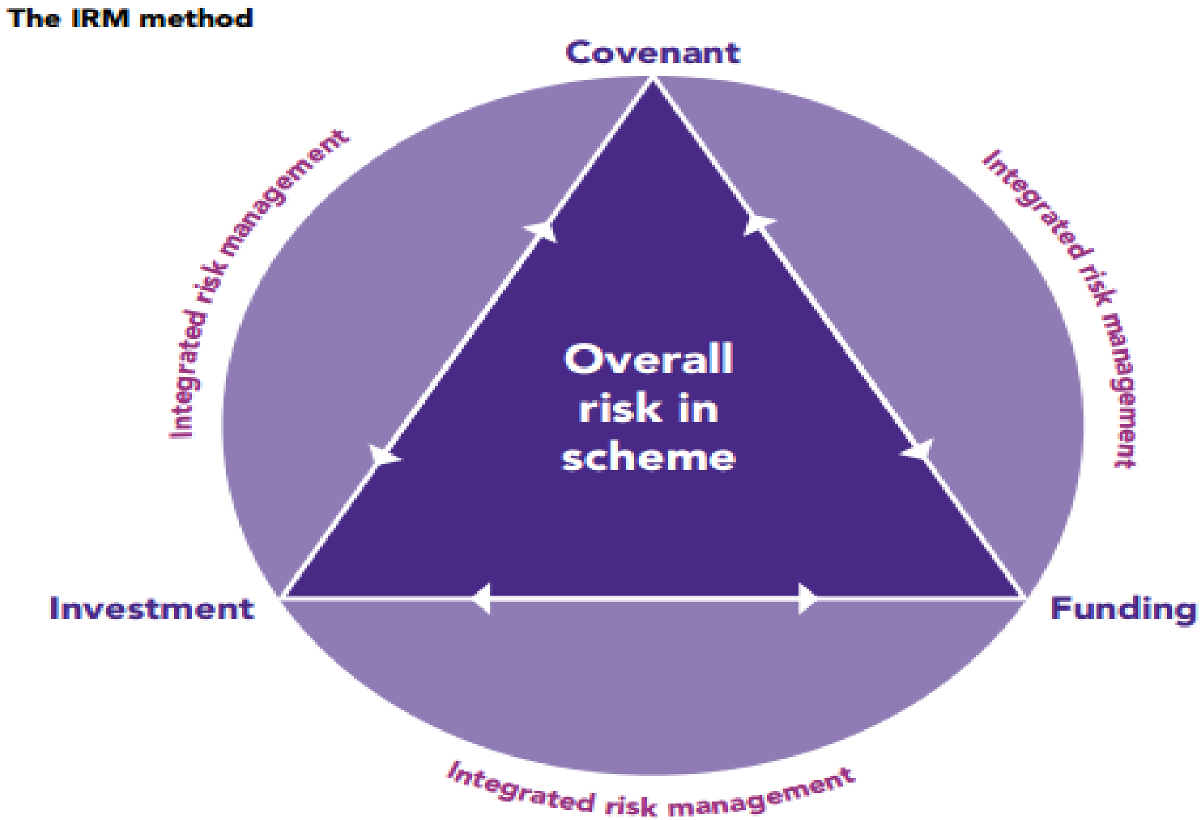
August 2015

The Pensions Regulator

Lincoln PENSIONS

Integrated Risk Management

Integrated Risk Management



Source: The Pensions Regulator, *Regulatory Guidance: Integrated risk management*, December 2015

TPR’s Guidance – Integrated Risk Management (“IRM”)

Employer Covenant is integral to the IRM debate:

- “Best to start with the Employer Covenant assessment... to determine the extent to which it can underwrite the risks” (para 28)
- Important trustees understand Employer Covenant as well as the scheme’s funding and investment positions before they take decisions which affect the scheme's funding (para 26)

“Ultimately the Employer Covenant underwrites the investment risks and funding risks”

Emphasis on advisory support:

- Advisors working together - "advisors who work well together should be able to help trustees make good decisions"
- Acknowledgement that an advisor may be best placed to set up the IRM

Integrating Covenant with Funding and Investment

Our nine-point Covenant rating scale is used by clients to inform their choices of funding assumptions, investment strategy and recovery plan structure

VERY WEAK | WEAK | FAIRLY WEAK | SLIGHTLY WEAK | NEUTRAL | SLIGHTLY STRONG | FAIRLY STRONG | STRONG | VERY STRONG

Illustrative assumptions

How might Covenant inform an appropriate investment strategy?

Investment strategy	All or mostly matching assets	All or mostly growth assets
Hedging	More	Less

How might Covenant impact reasonable funding assumptions?

Discount rate assumption	Solvency	'Best Estimate'
Other assumptions	More prudent	Less prudent

How might Covenant inform the recovery plan (before considering affordability)?

Initial recovery term	Shorter	Longer

Lincoln PENSIONS

Case study 1 – Manufacturer

Investment
- VaR95: £350m
- Investments: 63% equity 13% corp bonds 24% gilts / swaps

Is everything in balance?

Funding
- TP deficit: £200m
- Solvency deficit: £750m

Covenant
- Free cash: £35m (pre pens/div)
- Dividend: £25m
- Total assets: £500m
- Net assets: £90m (pre pension)
- Net debt: £120m

Case study 2 – Professional Services

Employer position

- Business performing well
- Majority cash flow for drawings
- Limited balance sheet
- Significant effort to limit volatility to align drawings with earnings (e.g. dilapidations)
- Intergenerational partner considerations important
- Reluctant to increase recovery plan contributions

Inherent conflict

Trustee position

- Scheme small in context of Employer's annual fee income
- £60m Scheme assets
- £15m TP deficit (and growing)
- £25m VaR95 – material
- £2m annual contributions
- 3 years left on recovery plan
- Covenant "Fairly Strong"

Not a typical affordability debate – focus on:

1. the **risk appetite** of the Sponsor
2. the fair treatment of the **Scheme as a stakeholder**

The Pension Funding Dichotomy

The Employer Covenant landscape - Where are we now?

Scheme funding

But thankfully…

Economic improvement

- Enabling higher deficit contributions to address the scheme risks…?

Key factors at play….

- Sponsors prefer to rely on investment performance
- “Sustainable growth” objective
- Trustees more comfortable about improving Employer Covenant
- Remember… the Employer Covenant is a relative thing

Corporate performance is improving, trustees are providing flexibility

However, this is building up risk in the system, placing greater strain on the Covenant to underwrite these risks in future

The "Pension Funding Dichotomy"

The Pension Funding Dichotomy:

- When times are good, Trustees can be more relaxed about Employer Covenant risk and the Sponsor's wish to maintain lower levels of contributions. <u>This leads to deficits not being funded and risks not being reduced</u>
- When times are challenging, companies may not be able to afford the level of contributions required <u>meaning deficits are not funded and risks increase</u>

- Bigger issue in cyclical industries

- <u>Remember</u> – don't wait until it starts raining before you fix the roof…

TPR's Guidance – Sustainable Growth

Assessing and monitoring the employer covenant – August 2015:

- "If the employer's plans to invest in sustainable growth restrict the funding available to the scheme, trustees should understand how the scheme will benefit by supporting this investment and whether other stakeholders are contributing appropriately." ***Executive Summary***
- "The employer's obligations to the scheme are likely to last for an extended period of time given the long-term nature of pension liabilities. It is therefore in the scheme's interest that the employer is able to adequately invest in the sustainable growth of its business so it can continue to support the scheme in the long-term."
- "Although such investment can constitute a significant call on the employer's discretionary cash alongside the required contributions to the scheme, many employers are likely to be able to afford both. But where investment in growth is likely to restrict the funding available to the scheme, it is important that trustees understand the employer's plans as part of their assessment of affordability." ***Section 2***

Sustainable Growth – practical steps

Trustees and employers must take certain steps

Risk that sustainable growth could prove to be a rogues' charter

- Communication
- Onus is on the employer to make the case
- Trustees need to assess and challenge the case
- Understanding the context of an employer's circumstances and objectives
- Trustees shouldn't be second guessing employer's business and investment decisions
- Capex: sustainable growth vs. maintenance and replacement (discretionary?)

Sustainable Growth – practical steps

Key questions

1. **How will the employer's growth plans impact the covenant?**
   - *what's the case?*
   - *is the investment in our employer?*
2. **When will growth be able to fund an increase in contributions?**
   - *jam tomorrow?*
   - *how do trustees ensure that the scheme sees the benefit?*
3. **Are other stakeholders contributing appropriately?**
   - *shareholders – dividends, rights issue?*
   - *appropriate use of debt?*
   - *is the scheme being asked to take the strain?*
4. **Can scheme security be improved by contingent assets?**
   - *can we mitigate the increased credit risk?*

The Evolution of Employer Covenant Assessment

The Evolution of Employer Covenant assessment

TPR guidance has led to material changes in assessing Employer Covenant

Area of focus	2010 approach	2015 approach
Relevant deficit	TP deficit (at valuation date)	Also consider VaR
Investment risk	Not expressly considered	"Does the Covenant effectively underwrite the investment risk in the scheme?"
Correlation of scheme and Covenant risks	Not expressly considered	Increasing appreciation and required awareness
Affordability	"quickly as is reasonably affordable"	What "sustainable growth" means for my Employer? Focus on discretionary cash flows and overall "financial flexibility"
Is the scheme being treated fairly?	TP deficit covered over a reasonable period (10 years)	Consider pension in relation to other financial stakeholders (equity / debt)
Primary use of Covenant output	Drive TP assumptions and affordability…	…now Covenant is also a key factor in settling investment risk budgets
	Focus on repairing the TP deficit	***Holistic view of scheme risk***

Lincoln PENSIONS

Questions?